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I am sure that all of you have had experience with the new investment credit. Undoubtedly, you encountered it in the preparation or review of returns for 1962, but at that time Regulations were not available and uncertainties developed as the attempt was made to apply the statutes to specific situations. Proposed Regulations have now been issued, and this paper will be an attempt to explain in as simple terms as possible the significant portions of the law as interpreted by the Regulations.

AMOUNT OF CREDIT

The investment credit was a part of the Administration's program to encourage business by permitting tax relief for taxpayers purchasing new and used equipment. Relief took the form of a credit against tax, not a deduction or an adjustment of rate. As you know, the credit is 7 per cent of the qualified property (a lesser percentage for utilities). The law contains a limitation on the amount of credit available in any given year; the credit cannot exceed $25,000 plus 25 per cent of the tax in excess of $25,000. If the taxpayer has an investment credit greater than the amount allowable under this limitation, the excess will be carried back for three years (but not before 1962) and forward five more years. If the credit is not utilized within this eight-year period, then the unused balance will become a deduction in the ninth year. The limitations are applicable in connection with married couples; if a joint return is filed, the $25,000 plus 25 per cent is allowed on the joint return. But if separate returns are filed, then the allowable amount is limited to $12,500 for each separate return plus 25 per cent of the tax in excess of $12,500. In the case of affiliated groups, the $25,000 must be apportioned between the members of the group on an equitable basis. The proposed Regulations provide for an election to be made by the affiliated group as to the corporation to which the limitation is to be applicable;[1] that is, the affiliated group, whether

[1] Proposed Reg. 1.46-1(f)

filing consolidated returns or not, is entitled to designate one or more corporations to utilize the full $25,000 of the credit.

The computation of the credit is relatively simple; it is 7 per cent of qualifying property, depending on the useful life of such property. In order to qualify the property must have a life of four years. If the life is between four and six years, one-third of the property is treated as qualifying; if between six and eight years, two-thirds is so treated; and if eight years, the entire amount is treated as qualifying property.

QUALIFYING PROPERTY

The first type of property qualifying is tangible personal property. This classification is comparatively simple; it consists of machinery, equipment, and similar types of assets subject to depreciation. It will include types of assets that under State law might be considered real property; that is, it may include items affixed to the real estate, but which, nevertheless, are not a part of a building or a structural component thereof but partake more nearly of the nature of machinery and equipment. The second type of property is other tangible property used as an integral part of manufacturing, production, or extraction, or generally in connection with business activities as such. This category does not include a building or its structural components; such items are specifically excluded from section 38 property. This category will include a variety of improvements subject to depreciation, but not within the category of tangible personal property. It is my feeling that it will include such items as wells drilled on a farmer's property, ditches used for irrigation, various improvements relating to farming or ranching or feed-lot operations other than buildings as such. It should include parking areas essential to the operation of the business and an integral part thereof. The Regulations contain a limited list of illustrative types of expenditures that will qualify. It is my general feeling that any expenditure resulting in a depreciable asset, not a building or an intangible asset, has a good chance of being included within this category. There will be many doubtful items, but it seems advisable to claim any doubtful item until further clarification has been achieved through final regulation or subsequent ruling or court decision.

Building and Structural Components

Buildings and their structural components are specifically excluded from the category of section 38 property. Generally speaking, buildings will be easy to identify, although in some cases where the building is a special-purpose building related only to the machinery covered, it appears that the building itself may be classified as section 38 property.[2] Questions will arise about the meaning of the term "structural components." The Regulations indicate that buildings include such items as plumbing, wiring, elevators, partitions, and floor coverings. Questions will arise relating to some of these items: Are removable partitions part of the building or are they not tangible personal property not attached to the building? What is the status of a substantial renovation of a building—that is, what portions of a complete renovation or conversion of, say, a warehouse into an office building can be treated as section 38 property? Or will it be necessary to consider all portions of such expenditure to be the cost of buildings not within the scope of section 38? It is my feeling that at least a portion of such expenditures may well be treated as other tangible property forming an integral part of manufacturing or other activity. It seems clear, however, that the Regulations treating the cost of elevators as a part of the building[3] are correct, because the proposed 1963 Revenue Act contains a provision that would grant the investment credit for elevators and escalators constructed after July 1, 1963.

Other Exclusions

The law contains additional exclusions; no credit is allowed for property used outside the United States, nor for property used by tax-exempt organizations, nor by the government. Likewise, no credit is allowed for livestock purchased, even though such livestock constitutes a depreciable asset. Property used for lodging is excluded, except that if the property belongs to a hotel or motel having a transient business, it will be qualified for investment credit purposes. It is difficult to understand why the investment credit was excluded on lodging and permitted for hotels and motels; this is an area that seems extremely fuzzy and that will create innumerable problems in application. Fortunately, it relates to a restricted group of taxpayers. Although not a specific exclusion, the terms of the law eliminate intangible property of all kinds from classification as section 38 property, even though such intangible property may require a depreciation deduction.

[2] Proposed Reg. 1.48-1(e)(1)
[3] Proposed Reg. 1.48-1(e)(2)

New Or Used Property

The credit is allowed on all new property with a useful life in excess of four years, regardless of total amount, even though for property held between four and eight years the amount subject to credit is scaled down. There is no limitation on the total amount of the credit that can be obtained from the acquisition of qualified new property. Used property, however, is different in that only $50,000 of such property will qualify. Where there is an affiliated group, or where a taxpayer receives credit allocations from partnerships or Subchapter S corporations, or where separate returns are filed between spouses, the $50,000 is an aggregate figure from all sources. Moreover, the $50,000 is an aggregate source for any reporting entity, including a partnership, so that the question of whether property is new or used may be significant. Used property acquired from a related taxpayer or in a sale and leaseback does not qualify for this purpose. Where there is an excess of used property over and above the $50,000 limitation, the taxpayer may select the portion of the property comprising the $50,000 to be used as section 38 property, and generally he will select the assets with a life in excess of eight years so as to obtain the full investment credit.

Determination of Cost

Special problems may occur in connection with the determination of cost. Where trade-ins occur and the taxpayer has a nontaxable exchange with a boot payment, the question will arise of whether the total basis of the asset acquired is the proper amount or only the cash payment in connection with the exchange. The regulations take the position that it is only the boot on used property that is subject to the investment credit,[4] whereas basis is applicable on new property. Involuntary conversions produce a rather difficult situation. The rules here appear to be unnecessarily complicated and generally penalize the taxpayer the maximum possible amount.

Where property was in construction during 1961 and perhaps completed and put into service in 1962, an allocation is required. This is similar to the problem that occurred in connection with the 1954 Code under which accelerated depreciation was permitted for the first time for property acquired after January 1, 1954. In connection with the investment credit, the portion of property constructed or

[4] Proposed Reg. 1.48-3(b) (1)

allocable to 1961 is not section 38 property, but the portion applicable to 1962 will qualify. As before, facts may arise in practice to render a solution difficult, but in theory it is simple.

LEASED PROPERTY

The investment credit has numerous special situations that create more or less difficult problems. One of the more difficult is the relation of the investment credit to a lessor-lessee situation with particular reference to leasing-company activities. The Code and the Regulations provide for an election under which the lessor, while the actual owner of the property, will be permitted to pass through the credit to the lessee provided appropriate forms are filed by both the lessor and the lessee. The election must be made by the lessor, but in practice it seems clear that if the lessee requests the benefit of the investment credit, generally the lessor will acquiesce. In practice, I believe most leasing companies will provide for a flow-through of the credit on request of the lessee, except for leases where small amounts are concerned or, of course, where assets have a life of less than four years. If the lessee, as a result of the option of the lessor, obtains the benefit of the investment credit, it will be necessary for the lessee to reduce by 7 per cent the deduction for rent payable to the lessor. Rather detailed proposed regulations cover the relationship of lessor and lessee, and for those interested they should be studied carefully.[5]

SPECIAL TYPES OF TAXPAYERS

Affiliated groups have problems in addition to those of most taxpayers. We have referred already to the requirement for apportionment of the $25,000 limitation. The same sort of limitation applies in connection with the used property limitation. If the affiliated group files a consolidated return there will, of course, be a consolidated investment credit subject to apportionment; but if separate returns are filed, apportionment problems must be considered. All corporations within the affiliated group, whether includable or not, are treated as within the scope of the limitations and, for purposes of the used property limitation, a 50 per cent ownership in stock is all that is necessary to constitute a corporation a subsidiary rather than the 80 per cent required for purposes of consolidated returns.

A Subchapter S corporation is treated for investment credit purposes as a conduit. The investment credit is apportioned to the

[5] Proposed Reg. 1.48-4

shareholders at the close of the taxable year of the Subchapter S corporation in proportion to their shareholdings and must be divided between new and used property for such purposes. The used property limitation of $50,000 applies here; this is the maximum that may be apportioned to the shareholders. The asset basis will be adjusted by the Subchapter S corporation and the shareholders will be allowed their shares of the appropriate investment credit.

Partnerships are treated as a conduit for purposes of the investment credit as well as for other functions. The individual partners are entitled to their proportionate shares of varying types of section 38 assets and such items are taken up by the individual partners on their several individual returns. However, for purposes of the $50,000 used-property limitation, the partnership is treated as an entity and the total amount of used section 38 assets permissible is $50,000. Estates and trusts, likewise, are treated either as conduits or as taxpayers, depending on the terms of the trust or the condition of the estate.

Certain other types of taxpayers have different rules. Savings and Loan Associations are treated separately; they are entitled to half of the benefits accorded other taxpayers. Coöperatives, regulated investment trusts, and real estate trusts are treated specifically in accordance with specialized rules. The credit for utilities is 3 per cent rather than 7 per cent; the mechanics of computation permit only $3/7$ of the amount determined for other taxpayers. Seven per cent of $3/7$ of property works out at 3 per cent.

ADJUSTMENT TO BASIS

So far everything has been good for the taxpayer, and, were it not for the basis adjustments required by the statute, this would be clear net profit. Unfortunately, the statute requires an adjustment of basis for the amount of the investment credit. This provision has caused more difficulty and confusion than any other single part of the investment credit. From a practicing tax accountant's point of view, the worst problem here is the built-in difference between Federal and State depreciation. So far as I know, the investment credit is not allowed by any state, hence depreciation for Federal and State purposes will necessarily vary because of the basis adjustment required for Federal purposes. For large amounts the basis adjustment is worth while, but for small items it is a nuisance. Because the basis adjustment resulting from the investment credit is mandatory, the taxpayer is in the position of being required to claim the credit even though he might wish to forgo the so-called benefit. Fortunately, the proposed changes in the 1963 law will not require further basis adjustment for the investment credit and will restore basis that has been reduced in prior years, although no refund will be allowable for such prior years. If for no other reason most accountants would like to see the Revenue Act of 1963 become law.

EFFECT ON EARNINGS AND PROFITS

An interesting problem and one to which there is no real solution as yet is the effect of the investment credit on earnings and profits. We all recall the problems of the American Institute of Certified Public Accountants in setting up an accounting technique for the investment credit. The Institute finally hammered out a rule to which there were dissents. The question, however, of earnings and profits is something entirely different, and the only pronouncement on this subject is a TIR[6] in which the Treasury states that the investment credit reduction of basis has no effect on earnings and profits. It is difficult to follow the Revenue-ruling reasoning. The reduction of income tax in itself causes an increase in earnings and profits because of the reduction of income tax. To say that the mandatory reduction of basis has no corresponding or offsetting effect on earnings and profits seems unrealistic to say the least. It would seem that the reduction of basis should be accompanied by a reduction of earnings and profits equal at least to the tax benefit, but probably in an amount equal to the reduction of basis. It is my personal opinion that there should be a charge against earnings and profits for the amount of basis reduction and that for purposes of a "tax balance sheet" this is the way the investment credit should be handled. It is my further feeling that this Revenue ruling is not the last word on the effect of the investment credit on earnings and profits.

EARLY DISPOSITION

The other unpleasant aspect of the investment credit is the tax effect of an early disposition of the asset. If an eight-year asset is retained for the entire eight years and the taxpayer had sufficient income and tax to utilize the full credit, the taxpayer has gained an amount equal to the difference between the credit allowed and the depreciation on the credit, namely, for a large corporation, 48 per cent

[6] TIR 458

of the investment credit. If, however, the taxpayer disposes of the property before the expiration of its assumed life, then he might have had an advantage unless a portion, at least, of the investment credit is restored to tax. For example, assume an eight-year type asset is in fact disposed of in six years. Originally, taxpayer claimed 7 per cent of the cost of this asset, but this was on the basis that the asset would be held for eight years. Since it is held for only six years, only two-thirds of the investment credit should be allowed. Therefore, the statute provides that on a disposition the portion of the investment credit that would not have been allowable had the earlier life been known must be restored to tax in the year of disposition. A comparable amount is then restored to basis. Dispositions for purposes of this statute are almost all-inclusive; the only real exceptions are the death of the taxpayer or a reorganization in which the transferee must step into the shoes of the transferor. Even a gift is a disposition for this purpose.

This section will provide many headaches in future years. Revenue agents may ask whether assets on which investment credits have been claimed are still retained during the several years; and where itemized asset records are maintained, this will be a fairly simple matter. But where composite rates or multiple units are concerned, it will be extremely difficult to identify the assets. It is possible to foresee that real problems will arise in identifying and tracing in connection with this section, and the effect probably will be that a great deal of time will be wasted, both by the taxpayer and by the Revenue Agent in order to ascertain whether a relatively small amount should be added to basis and to tax in the year of disposition. This is particularly true where composite depreciation is used, because there would be no necessary identifiable event to pinpoint the possible disposition of the asset. This is true, likewise, where there is a trade and the basis of the acquired asset includes the basis of the transferred asset. It is entirely possible for practical problems to ensue that may almost eliminate the desirable results expected by the framers of this statute.

CONCLUSION

The foregoing discussion is a brief and incomplete résumé of the investment credit. Like all other tax statutes and procedural changes, particularly those introduced by the present Administration, the provisions are complex and appear unnecessarily difficult. Why all exceptions were considered necessary is uncertain, and certainly the basis reduction and the problem arising from disposition could have been handled more simply. Perhaps it is another instance of the desire to prevent unemployment among tax accountants and attorneys.